Financ Mark Portf Manag (2010) 24: 453–454
DOI 10.1007/s11408-010-0145-7

BOOK REVIEW

Francis X. Diebold, Neil A. Doherty, and Richard J. Herring: The known, the unknown, and the unknowable in financial risk management

Princeton University Press, 2010

Tobias Nigbur

Published online: 8 October 2010

The Known, the Unknown, and the Unknowable in Financial Risk Management is a collection of articles on financial risk management that came out of two conferences of academics and practitioners that were organized by three professors: Francis X. Diebold, Neil A. Doherty, and Richard J. Herring of the Wharton School, University of Pennsylvania. Their ambitious goal was to create a book that would be appealing and worth reading for both academics and practitioners.

The underlying idea of the book is the separation of financial risks into three tranches: known risks, unknown risks, and unknowable risks (KuU), an approach adopted from a famous 1995 article by Ralph Gomory. The authors propose that the KuU perspective enhances understanding of the diverse and complex field of financial risk and can also help in managing these types of risk.

The book contains an introduction and 14 articles. All articles establish a relationship to *The Known, the Unknown, and the Unknowable.* The introduction by Diebold, Doherty, and Herring is a guideline for the book. It starts by setting out the motivation behind and a definition for KuU, giving concrete examples. Later on, the authors paint a big picture of what kind of risk one can face in finance and discuss how the subsequent articles are connected to this topic.

The first article, by Sir Clive W.J. Granger, deals with risk and its measurement for decision makers, including utility theory and mean variance valuation. Benoit B. Mandelbrot and Nassim Nicholas Taleb provide evidence of and a solution for the failure of the Gaussianity assumption by using fractal distributions. The third article, by Riccardo Colacito and Robert F. Engle, presents a long-run model for volatility forecasts and its application to asset allocation. A multiple-regime stress-loss risk

T. Nigbur (✉)
Swiss Institute of Banking and Finance, University of St. Gallen, Rosenbergstrasse 52,
9000 St. Gallen, Switzerland
e-mail: tobias.nigbur@unisg.ch

framework and its application to hedge fund strategies is the topic of the article by Robert H. Litzenberger and David M. Modest. Andrew Kuritzkes and Til Schuermann collect sources of banking risk. A guide through the history of real estate and its risk exposure today is offered by Ashok Bardhan and Robert H. Edelstein. The seventh article, by Paul R. Kleindorfer, discusses decision making under uncertainty. The next two articles discuss KuU as it is related to insurance. First, Neil A. Doherty and Alexander Muermann argue that insurance brokers can solve market inefficiencies by risk sharing. Second, Howard Kunreuther and Mark V. Pauly investigate changes to both the supply and demand side of the insurance market caused by various catastrophes. Next, comes an article by Charles N. Bralvers and Daniel Borges about the role of the CFO exposed to increased market intensity, after which Kenneth E. Scott focuses on the relationship between corporate governance and risk. Charles A.E. Goodhart explores domestic banking problems and regulations; Donald L. Kohn writes about crisis management. The last article is by Richard J. Zeckhauser and concerns different investment decisions, providing various examples.

The book closes with personal information about the contributors.

In my opinion, this collection of papers from well-known scholars reaches the book's ambitious goal. It treats a broad range of topics within the financial world and offers suitable weightings. Due to this broad design, one cannot, of course, expect technical details or many complex models-the book is intended to be an overview. The approach of classifying risks into known risks, unknown risks, and unknowable risks is quite appealing and feasible. In contrast to much of the financial risk literature, this book focuses mainly on unknown and unknowable risks, meeting a steadily growing demand for understanding and describing these special kinds of risks, especially in light of the recent financial crisis.

Additionally, the book is easy to read and understand. Some articles begin by discussing the historical evolution of their topic. Peppered with anecdotes and prominent examples, the book never abandons the practical side of its topic. It will be helpful for readers interested in only specific subtopics that each article is a stand-alone piece.

I recommend this book to a wide audience: academics and practitioners, of course, but even people who are not directly involved in the financial sector, but are interested in it, will find it definitely worth their time.